Securities Industry Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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TAX COMPLIANCE TRENDS: REVIEW AND OUTLOOK

HIGHLIGHTS

1. Initial TEFRA proposals to improve taxpayer compliance would have imposed extremely costly and unreasonable tasks on financial intermediaries. As it is, the financial services industry is committing considerable resources to comply with the new reporting requirements. Given the continued pressure to reduce projected deficits, financial intermediaries may well face additional burdens in the future.

2. The estimated tax gap for 1981 is $81.5 billion for the legal sector, with $52.2 billion attributed to unreported individual income. The largest single problem for the IRS is individuals who do not accurately report their income.

3. The figures quoted by IRS and Treasury in 1982 constituted ample fuel to send Congress on a mission to close the taxpayer compliance gap. However, the most recent years for which actual measures of noncompliance are available are 1976 for filers and 1977 for nonfilers. Thus, the noncompliance figures cited for 1979 and 1981 which were used to initiate specific legislation are, at best, only rough estimates.

4. The underlying point for all tax compliance proposals is, of course, the yield ultimately produced. For example, gross proceeds reporting is estimated at generating additional revenues of $22 million in 1983 and $120 million in 1984. Given the substantial costs to the private sector and a triple digit deficit, it is doubtful that such regulations are cost effective approaches to reducing the deficit.

5. While the system of cross checks and balances may become increasingly elaborate, the question remains: will the IRS have sufficient resources to make use of the information received and to follow up on the noncompliant taxpayer. There are probably insufficient resources to adequately use the plethora of information that will be received under TEFRA.

Introduction

The Economic Recovery Tax Act of 1981 (ERTA) represented the largest tax cut in history--almost $750 billion over a six-year period. The feeling of elation over the 1981 tax cuts disappeared early in 1982 as Congress and the business community became increasingly concerned with an escalating Federal budget deficit. However, Congress and the President were stalemated as to how to redress the problem. There was both a reluctance to make additional spending cuts and an unwillingness to pass a general tax increase or tamper with the third-year tax cut. In the search for measures to dwarf the escalating deficit, IRS/Treasury studies and recommendations concerning growing taxpayer noncompliance gained in significance and political appeal. Thus, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the largest revenue-raising bill in history, was designed to raise an additional $98.3 billion in revenues over a three year period. The individual taxpayer would feel the bill's effect mainly through improved tax collection and enforcement efforts.

Initial proposals to improve taxpayer compliance would have imposed extremely costly and unreasonable tasks on financial intermediaries. As it is, the financial services industry is committing considerable resources, both in actual outlays and manpower, to comply with the new reporting requirements. This Trends issue will review the taxpayer compliance problem, the development of TEFRA, and prospects for further compliance-tightening initiatives. Much of the discussion represents summaries of government work in this area. Government will be under pressure to reduce the deficit for some time to come and closing the estimated taxpayer compliance gap seems to be the path of least resistance. Financial intermediaries are now feeling the brunt of recent increased reporting requirements and may well face additional initiatives in the near future. The following aptly sums up sentiment by some policymakers who favor "limited new burdens on highly automated third party payors":

> This allocation of the burden is proper not only because payors can most efficiently carry the new reporting (or withholding) responsibility but also because there is no alternative. Compliance levels would be unsatisfactory absent such an allocation.*

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* John Andre LeDuc, "An Evaluation of Recent Taxpayer Compliance Legislation and Future Options," Tax Notes, 7/11/83.

The Compliance Problem*

The American tax system is based on the principle of voluntary assessment. Through the tax system, government garners the revenues to finance 90% of its activities. It is argued that a voluntary compliance system is the most efficient and effective approach to collecting taxes and is likely to promote the highest degree of public acceptance of this basically unpopular government function. In 1982, individuals voluntarily filed about 96 million returns and paid $352.6 billion in income taxes. Total revenue collections from all sources amounted to $632.2 billion. Based on 1981 data, IRS operating costs totaled $2.5 billion, resulting in an average cost of 41 cents for every $100 collected.

Despite the collection of what seems like vast sums, IRS statistics show that the percentage of income voluntarily reported by individuals has steadily declined. According to IRS estimates, the legal sector tax gap has grown from $28.8 billion in 1973 to $81.5 billion (see Table I). Voluntary taxes paid by all sectors may have fallen short of the 1981 tax bill by as much as $90.5 billion, with $75.3 billion attributed to individuals, $6.2 billion attributed to corporations, and $9.0 billion attributed to illegal source income. Of the $75.3 billion in estimated 1981 individual taxes lost, unreported income accounted for $52.2 billion. The largest single problem for the IRS is individuals who do not "accurately" report their income. Failing to report income accounts for more than two times the lost tax revenue from the combined results of overstating tax deductions and other "offsets" to income, failing to file returns, and not paying assessed taxes.

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* Much of this section is a summary of Further Research Into Noncompliance Is Needed to Reduce Growing Tax Losses, A Report to The Congress by the Comptroller General, Government Accounting Office, 7/23/83; and Income Tax Compliance Research, Treasury/IRS, Office of the Assistant Commissioner, Research Division, 7/83.

TABLE I

INCOME TAX GAP, 1973-81
($ Billions)

	1973	1976	1979	1981
Legal sector tax gap, total	$28.8	$39.2	$62.3	$81.5
Corporation tax gap, total	3.5	4.6	6.4	6.2
Individual tax gap, total	25.3	34.6	55.9	75.3
Individual income tax liability reporting gap, total	23.8	32.2	50.6	68.5
Nonfilers' income tax liability (Net of prepayments and credits)	0.9	1.4	2.0	2.9
Filers' income tax liability:	22.9	30.8	48.6	65.6
Unreported income	17.3	24.2	38.4	52.2
Overstated business expenses	2.1	3.4	4.7	6.3
Overstated personal deductions[1/]	3.4	3.0	5.0	6.6
Net math errors	0.1	0.2	0.5	0.5
Individual income tax remittance gap, total	1.5	2.4	5.3	6.8
Employer underdeposit of withholding[2/]	1.1	0.9	1.8	2.4
Individual balance due after remittance	0.4	1.5	3.5	4.4
Illegal sector tax gap (partial)[3/]	2.1	3.4	6.3	9.0
	(0.8)	(1.3)	(2.2)	(3.2)

Source: Income Tax Compliance Research, IRS, 7/83

1/ Includes itemized deductions, personal exemptions, and statutory adjustments.

2/ Also includes a small amount for underreported withholding by employees and a small negative amount for underclaimed withholding by individuals.

3/ Includes income from illegal drugs, illegal gambling, and prostitution only. Figures in parenthesis are standard errors.

Regarding unreported wages, a Harris Poll conducted for Business Week indicated that as many as 30% of all American households have some member working in the underground economy.* Even these results have to be taken with "a grain of salt," as most individuals would be reluctant to admit that they are hiding income. The reasons for the decline in voluntary compliance are elusive, running the gamut from total ignorance to willful

* "Answers that unveil the underground economy," Business Week, 10/11/82.

evasion. A recent article attempted to sum up the "psychology" of the taxpayer. The individual's perception of the tax code is based on: 1. widespread awareness that others are cheating; 2. a "gimmick" or exception riddled tax code that fails to convince the taxpayer that paying taxes is an intelligent and decent thing to do; and 3. publicity of federal waste or mismanagement of tax revenues.*

The IRS has not been any more successful in identifying what makes people comply with tax laws than independent researchers. The IRS believes that examination of tax returns, the largest of its nine compliance programs, yields a significant positive effect on taxpayer compliance. In 1982, IRS examined 1.7 million tax returns, with coverage of income, estate, and gift tax returns at 1.6% of such returns filed. Based on the 1982 examinations, additional assessments and penalties totaling $11.7 billion were recommended, $3 billion of which related to individual tax returns. In addition, IRS service center contacts were made for about 700,000 returns which resulted in proposed tax assessments totaling about $268 million. IRS believes that the compliance for a taxpayer class correlates positively with the examination coverage for that class; and that given certain high rates of examination coverage, voluntary compliance will over time approach 100%.

Nevertheless, IRS reports that normal audit procedures are unsuccessful in detecting unreported income. IRS estimates indicate that even the most intensive examinations detect only about 25% of the income not reported by those taxpayers audited. To carry this fact one step further, the IRS cannot rely heavily on its normal, less intensive audits to detect unreported income.

IRS also believes that its information returns program (IRP), wherein third-party documents are matched with tax returns, significantly affects voluntary compliance. However, in the past, only a relatively small share of compliance resources was allocated to this program. For example, 5% of total compliance resources was allocated to IRP in 1981. In that year, IRS received 664 million information documents, 435 million of which were from business and organizations reporting interest, dividends and other payments. About 80% of these documents were compared with the related tax returns. Document matching resulted in additional tax assessments totaling about $500 million for cases generated in prior years and completed in fiscal year 1981.

Estimates of Unreported Income

In July 1983, IRS released a report, Income Tax Compliance Research, which it believes is its most comprehensive attempt to date to estimate noncompliance in the U.S. While the figures

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* Washington Magazine, 4/82.

provided in this report were apparently quoted in 1982 as TEFRA was being structured, neither the report nor methodology were made available for public comment and scrutiny at that time. For the individual sector, the estimates of underreported income and overstated items are based on data from IRS's Taxpayer Compliance Measurement Program (TCMP). The most recent year for which actual measures of noncompliance from this source could be used is 1976. For nonfilers, the most recent data on actual unreported income is 1977. Thus, the noncompliance figures for 1979 and 1981 are estimates, and nothing more.

According to the data in Table II, unreported legal source income escalated from $93.9 billion in 1973 to $249.7 billion in 1981. Unreported wages and salaries rose at a 184% pace, while the majority of other categories increased by somewhat less. The exception is investment income which was estimated at rising even faster than wages and salaries.

TABLE II

Unreported Legal-Source Income of
Individual Filers & Nonfilers, 1973-81
($ Billions)

	1973	1976	1979	1981
Wages & Salaries	$33.3	$ 46.3	$ 71.1	$ 94.6
Dividends	1.9	3.6	5.5	8.7
Interest	4.4	6.8	11.5	20.5
Capital Gains	5.0	9.9	16.3	17.7
Nonfarm Proprietor, Partnership & Small Business Income	23.9	32.6	47.2	58.4
Farm Proprietor Income	5.7	4.5	7.8	9.5
Informal Supplier Income	10.3	12.7	17.0	17.1
Pensions & Annuities	3.1	4.1	6.3	8.8
State Income Tax Refunds, Alimony, & Other	4.0	6.8	6.3	7.1
Other 1/	2.1	4.2	5.5	7.2
Total	$93.9	$131.5	$194.5	$249.7

Source: Income Tax Compliance Research, IRS, 7/83.

Note: Total may not add due to rounding.

1/ SIA residual category.

Reviewing components as a percentage of the estimated total, unreported wages and salaries by and large account for the lion's share of noncompliance, $94.6 billion or 37.9%, followed by nonfarm proprietor, partnerships, and business income at $58.4 billion or 23.4%. While investment income has moved up in the rankings of percentage share of unreported income, it is still dwarfed by unreported salaries and business income. As a percentage of 1981's total unreported income, interest represented 8%; capital gains, 7%; and dividends, 3.5%.

Given that the period 1973-81 was subject to bouts of double digit inflation, IRS believes that the underlying tendencies can be overshadowed if noncompliance is measured only in current-dollar terms. Therefore, to determine the "hidden trends" in the raw data, the IRS recasts the measure into voluntary reporting percentages (VRPs). VRPs relate sums voluntarily reported to sums that should have been reported based on IRS estimates.

Overall voluntary reporting of all income slipped from 91.2% in 1973 to 89.3% in 1981, or at a rate of about two-tenths of a percentage point each year over this period (see Table III). The most serious decline in compliance was reportedly in capital gains income, for which the 1973 compliance rate was already among the lowest according to IRS estimates. The estimated voluntary reporting percentage for capital gains income declined from 75.7% in 1973 to 59.4% in 1981, an average decline of slightly more than 2 percentage points per year. While the percentage of interest voluntarily reported changed little over the 1973-81 period, dividends reported took a sharp fall from 90.7% to 83.7%. Nevertheless, estimated voluntary compliance for interest and dividends is still relatively high.

TABLE III

Estimated Reporting Percentages for
Individual Filers & Nonfilers, 1973-81

	1973	1976	1979	1981
Wages & Salaries	95.3%	94.9%	94.4%	93.9%
Dividends	90.7	87.1	85.7	83.7
Interest	87.6	88.1	86.3	86.3
Capital Gains	75.7	64.3	63.4	59.4
Nonfarm Proprietor, Partnership, & Small Business Income	84.0	82.2	80.7	78.7
Farm Proprietor Income	88.6	92.6	89.5	88.3
Informal Supplier Income	20.7	20.7	20.7	20.7
Pensions & Annuities	83.5	86.9	86.7	86.9
State Income Tax Refunds, Alimony & Other	66.0	55.2	62.3	62.0
Other[1/]	83.7	79.6	78.4	77.7
Total	91.2%	90.4%	89.8%	89.3%

Source: Income Tax Compliance Research, IRS, 7/83

1/ SIA derived average

Focusing only on 1981, Table IV depicts the actual with the projected income reported. The IRS relates the high percentages of voluntarily reported income to the effectiveness of withholding in the case of wage income and to information reporting in the case of interest, dividends, estate and trust income, and pensions and annuities. It is not surprising, therefore, that the mainstays of TEFRA's compliance measures were withholding and increased information reporting. What is surprising was the attempt to impose withholding on interest and dividends where compliance is high, as even the IRS concedes.

TABLE IV

Individual Income Tax Net Income Reporting Compliance, by Type of Income, 1981
($ Millions)

Type of Income	Reported on Tax Returns	Should Have Been Reported	Voluntary Reporting Percentage
Wages & Salaries	$ 1,455,154	$ 1,549,735	93.9%
Dividends	44,945	53,692	83.7
Interest	129,112	149,591	86.3
Capital gains	25,934	43,661	59.4
Nonfarm proprietor income (except informal supplier income)[1/]	53,580	106,522	50.3
Farm proprietor income[1/]	-2,051	11,095	--[2/]
Partnership and small business corporation income[1/]	14,859	31,604	47.0
Informal supplier income[1/]	4,465	21,545	20.7
Pensions and annuities	58,458	67,257	86.9
Rents[1/]	2,564	6,890	37.2
Royalties	4,361	7,131	61.2
Estate and trust income[1/]	3,869	5,215	74.2
State income tax refunds, alimony, and other income	11,700	18,866	62.0
Total income	$1,806,950[3/]	$2,072,804[3/]	87.2%

Source: Income Tax Compliance Research, IRS, 7/83

1/ Business incomes were estimated on a net basis, to make the voluntary reporting percentages (VRP's) for these sources of income reflect a second dimension of noncompliance in the possibility of overstated expenses.

2/ The VRP cannot be calculated since the reported amount is a negative figure.

3/ The difference between these two figures is $265,854 million, which equals the sum of total unreported income of $249,675 million and overstated business expenses of $16,179 million.

To derive estimates of underreported income, the IRS relied on its TCM program, which is conducted every three years, and its Information Returns Program. Based on the latest TCMP-IRP study, 1976, the ratio of total unreported IRP-covered income to the amount discovered by TCMP for income items for which IRS documents were available was conservatively estimated at 3.5 to 1. Thus, the ratio was applied to income items not covered by

information reporting, such as capital gains. The 3.5 multiplier, however, is based on a small subsample of the TCMP sample population and actual contact was made with fewer than 1,000 taxpayers.

The starting point for the unreported capital gains estimate is the 1976 "misclassified or unreported" capital gains figure of $3,361 million from TCMP. Allowing for 25% human error, 75% of the $3.4 billion was subsequently multiplied by 3.5. Projections for 1979 and 1981 were made by applying regression analysis to data from the Statistics of Income in 1980 and estimates for 1981 to determine what TCMP would have yielded. Projections of unreported income were first made for total income, and projections for particular types of unreported income were forced to this projected total by proportional adjustments. All in all, many assumptions were required on which early legislative initiatives requiring the reporting of capital gains were based.

Finally, in order to estimate the tax gap for individual filers, the estimates of understated taxable income is multiplied by an average marginal tax rate, which is derived via the Treasury's tax model. Table V displays select components of the estimated $52.2 billion tax gap generated by filers in 1981.

TABLE V

Unreported Income and Related Tax Gap,
by Type of Income, for Filers, 1981
($ Millions)

Type of Income	Unreported Income	Marginal Tax Rate in Percent	Tax Gap[1/]
Wages and salaries	$18,881	30.8%	$6,283
Dividends	6,596	42.6	3,027
Interest	12,120	32.8	4,286
Capital gains	15,241	43.4	7,136
Nonfarm proprietor income (except informal supplier income)	33,615	39.6	14,353
Farm proprietor income	8,499	27.3	2,504
Partnership and small business corporation income	10,786	44.7	5,195
Informal supplier income	13,848	30.8	4,608
Pensions and annuities	4,131	26.6	1,184
Other income[2/]	10,124	----	3,622
Total income	$133,840	39.0%	$52,198

Source: Income Tax Compliance Research, IRS, 7/83

1/ Components have been forced to the total by proportional adjustment.

2/ SIA residual category.

The Development of TEFRA

Clearly, the estimated figures quoted by IRS and Treasury in early 1982 constituted ample fuel to send Congress on a mission to close the tax gap, a mission which would mitigate the need to raise taxes. Indeed, all policymakers jumped on the bandwagon. In his State of the Union Address on January 26, President Reagan introduced a 5% domestic withholding tax on dividends and interest. Shortly thereafter, two bills were introduced, HR 5829 and S 2198, which presented an alternative to withholding. These bills focused on another area of noncompliance -- capital gains. While the possibility of the imposition of a withholding tax unleashed considerable public protest, the brokerage community was virtually horrified by the proposal to report capital gains. When introducing S 2198, Senator Robert Dole stated that "low-cost information reporting on capital gains in commodities and securities transactions would be required from the highly computerized securities and commodities brokerage industry."

Although the well-publicized paper crisis of the late 1960's had sent the securities industry scurrying to computerize, the sophisticated technology necessary to report capital gains and losses was simply nonexistent. In May, HR 6300 was introduced which replaced capital gains reporting with gross proceeds reporting, but kept the language allowing the Secretary the authority to require reporting of gains and losses. All of these bills substantially expanded the types of securities subject to information reporting and increased the penalties for various forms of noncompliance.

While the documentation for the noncompliance figures quoted by government has been recently released, none of this research work was available in 1982. This was particularly aggravating in the area of capital gains. The recently released study does show a 59% estimate of compliance for capital gains. However, this estimate includes gains in real estate, collectibles and other tangibles. Moreover, during the 1982 discussions, an informal government estimate placed compliance in capital gains in securities transactions at about 80%. A far cry from 59%! Nevertheless, although there is an obvious need to extend gross proceeds reporting to all assets giving rise to capital gains and losses, early on it became evident that this requirement would apply only to commodity and securities transactions -- the areas of highest compliance.

Despite credible and well-supported public testimony by SIA and representatives of other financial intermediaries plus countless informal meetings with government staff, TEFRA contained many provisions that placed a heavy resource burden on the private sector. The expanded interest reporting, broker information returns and withholding provisions of TEFRA, where workable, would cost millions of dollars. In some cases, the provisions were not only set in unrealistic time frames, but were clearly unworkable given current industry operational procedures and systems capabilities. Nevertheless, at least capital gains reporting would not be required.

Withholding on Interest and Dividends and Expanded Interest Reporting

Given its direct effect on almost the entire tax paying public, the 10% domestic withholding tax garnered national headlines. The outrage the public expressed over government withholding on their savings equated with the outrage of financial intermediaries over the nightmare implementation would bring. Although the issue of withholding is a moot point now, repeal does not preclude revisitation. Indeed, when initially introduced, few individuals thought the "old chestnut" had a ghost's chance of passage. It is worth recalling some of the major problems with withholding as envisioned under TEFRA.

Of all the problems faced by financial intermediaries, original issue discount (OID) identification was first and foremost. The temporary regulations for both withholding and

expanded interest reporting imposed requirements with respect to OID instruments that could not be complied with by financial intermediaries. It was a generally acknowledged fact that the financial community could not comply with the less extensive pre-TEFRA reporting requirements for OID issues. Simply stated, there is not one single reference source identifying those securities issued at a discount. The drafters of the regulations foresaw a "cascading" reporting system whereby the issuing corporation via a 1099 at year-end would alert securities firms that they were the owners of record of an OID during the past year. The securities firm, in turn, using its "highly sophisticated" computer capabilities would backtrack to identify the customers that held the OIDs. This was not feasible as firms cannot backtrack electronically into their systems. Finally, IRS was given the responsibility for publishing the OID listing. Industry and the IRS are currently working on producing an accurate list.

The withholding provisions did not parallel the reporting provisions in some cases necessitating a vast expansion of the items of information that were to be stored via systems and giving rise to considerable confusion. For example, the rules applied differently depending on whether the obligation was short- or long-term, in bearer or registered form, paid or did not pay interest and whether it was transferred or held to maturity by the original purchaser.

A host of other problems was contained in the preliminary withholding regulations. Unclaimed interest and dividends were to be withheld on immediately as though the payee were non-exempt. However, many of these funds are claimed within a period of months and are paid to exempt intermediaries. The delayed deposit rule, seemingly to compensate intermediaries for the cost of implementing withholding, was to be applied according to size of the intermediary, small, medium or large, over a one, two or three year period. However, the securities industry was classified as "large" and thereby entitled to a float for only one year. In addition, the securities industry was denied the election, which had been granted to other financial intermediaries, to defer withholding on certain types of accounts to year-end.

Information Returns of Broker

While not wrought with the complexities encompassed by withholding, the initial regulations on information returns of brokers were not without problems. Brokers were to report the repayment of borrowed securities and the cost of the property used for repayment. The broker, however, does not necessarily have this cost information. In addition, the proposed reporting of futures and commodities transactions required instituting a set of cumbersome procedures which would have required changes in the very conduct of day-to-day business.

The foregoing has only highlighted the major problems with the initial regulations for implementing TEFRA. Some of these problems were resolved with the final regulations, and some completely eliminated with the repeal of withholding. As to the remainder, the money and manpower spent by all financial intermediaries in preparing to implement TEFRA cannot be quantified easily. Most assuredly, there will be more money and manpower spent by industry in January, when customers become fully aware of the extent of TEFRA. The massive sweep of TEFRA and the time frame allotted for start-up virtually guarantee disruption for the financial services industry, the taxpayer and the IRS. Finally, one must question whether placing additional costs and burdens on the private sector to raise modest amounts of revenues is the most cost effective approach to reducing triple digit deficits.

Backup Withholding

The repeal of withholding while welcomed by all financial intermediaries left in its wake expanded provisions for backup withholding. To be sure, backup withholding to catch the taxpayer reluctant to give a social security number or purposely providing an incorrect number is a reasonable measure. However, the proposed manner of implementation, as detailed in the temporary regulations, leaves much to be desired.

The temporary regulations impose a $50 fine on financial intermediaries each time they fail to provide the IRS with a customer's correct social security number. The fine would be levied instead on the taxpayer if the intermediary could prove it had exercised "due diligence" in attempting to obtain the number. It is the due diligence requirements that are particularly harsh. Although couched in terms of options, in essence financial intermediaries will be required to canvass their entire customer base for certification of social security numbers by year-end. In the case of missing or incorrect social security numbers, notification would have to be sent by separate, first class mail.

The required mailings will be extremely costly and appear unnecessarily inflexible. It is, in fact, rumored that some financial intermediaries would risk the $50 fine per incorrect number rather than undertake the certain expense of the mailings. Other aspects of the temporary regulations are also troublesome. For certification purposes, accounts are to be defined as pre-1984 and post-1983. However, a pre-1984 account is to be defined on the basis of 1983 activity which is unworkable since systems are not designed specifically to backtrack into the year's activity. Government staff has gone so far as to suggest that, in lieu of the 1983 activity test, brokers treat all accounts as new accounts. Such suggestions are simply unacceptable. In addition, starting for 1984 and following years, 1099s must be sent in a separate mailing.

The Outlook*

Historically, the burden of the tax system fell on taxpayers in the first instance, and then on government. That clear allocation of the burden began to erode in 1942 with the introduction of wage withholding. The next major step came in 1962 with the expanded information reporting system for interest and dividends. In each case, the changes shifted the burden from the taxpayer and the government to the third party payor. The 1982 changes continue this trend.

Since enactment of TEFRA, Commissioner of the IRS Egger has testified that the IRS will not seek further legislation to improve taxpayer compliance. Some commentators would go so far as to suggest that Congress has overreacted and provided the IRS with too much authority. From the standpoint of the securities industry, quite a bit of time will be necessary to digest TEFRA. On the other hand, others view the TEFRA legislation as nothing more than a good first step at reducing the compliance problem. Moreover, the repeal of withholding on interest and dividends removed much of the "punch" of TEFRA. While it would be reasonable to suspend efforts to evaluate TEFRA until the system has been in place for several years and there are bona fide compliance estimates for those years, such a respite is unlikely. Preliminary IRS estimates of the compliance gap show a 28% increase from 1981 to 1985, notwithstanding TEFRA. The revenue loss is estimated at $100 billion annually. Coupled with the pressure on government to reduce the Federal deficit, the appeal of improving compliance will probably increase even more sharply over the next few years. Increasing "compliance" is, of course, more popular than raising taxes.

There are many options available for narrowing the compliance gap. One could assume that the repeal of withholding would preclude revisitation, at least politically, for a year or two but certainly not indefinitely. The IRS has repeatedly emphasized the superior effectiveness of withholding. The revival of withholding on interest and dividends remains a future option, as well as the extension of withholding to other areas of income.

The criticism of withholding is dismissed lightly by some in government. Regarding the argument that withholding is burdensome on taxpayers and financial intermediaries, the counterargument is that some taxpayers can avoid estimated taxes through withholding thereby reducing their paperwork. Second, it is argued that withholding is the least intrusive alternative to

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* Much of this section is based on three articles by John Andre LeDuc giving an overall assessment of the response of the 97th Congress to tax shelters and to the general problem of taxpayer compliance. These articles appeared in Tax Notes on 1/31/83, 6/20/83, and 7/11/83.

securing fuller compliance. Treasury estimates that a minimum 200% increase in audits and additional annual costs of $1 billion would be necessary to collect through information reporting the revenue which would be available from 10% withholding.

There may be few political stumbling blocks to a revisitation of the reporting of capital gains. The securities industry was successful in its plea for cost effective regulations in 1982 in this area. However, given government's perception of a highly computerized industry, there is nothing to prevent a reinvestigation of systems sophistication in the future. Should gross proceeds reporting prove insufficient at narrowing the estimated capital gains tax gap, this may very well rear its head again. Hopefully, the government will focus on sectors where the compliance rate on capital gains is poorest rather than highest as was done recently.

Broad Perspective on Improving Compliance

Approaches to improving taxpayer compliance run a broad range, from a public education system sponsored by IRS to increasing the risks associated with noncompliance. Although never quantified, part of the compliance problem is thought to stem from the complexity of the tax code and the frequent changes to it. Not that the byzantine structure of the tax code has gone unnoticed. There have been several attempts at reform legislation. However, given a patchwork rather than comprehensive approach, reform legislation has served to exacerbate rather than relieve the complexity of the code.

Comprehensive tax reform is an issue receiving much attention in recent months. Alternatives to our present system include consumption taxes, value added taxes and further refinement of the indexing provisions contained in ERTA. Of particular popularity has been the flat rate tax. In pure theory, a flat rate tax would impose one tax rate across-the-board on all income regardless of the source, thus flattening out the progressive structure of our current system and eliminating all credits, deductions, etc. The obvious trade off of any flat rate proposal is a substantial broadening of the tax base. However, just as the greatest appeal of the flat rate tax lies in its simplicity, its greatest coup would be in emerging from Congress in that form. At this point in time, most observers believe the flat rate tax is an interesting concept but is still a long way off in practice. Thus, we are "stuck" with the present tax structure.

Summary

There is little doubt that noncompliance with U.S. tax law exists. The cause of this noncompliance and what to do about it present complex problems to wrestle with. However, solutions of "what to do about it" have fallen increasingly on the private

sector. This need not be the case. For example, the IRS is initiating an experiment whereby demographic informatin will be purchased from marketing and direct-mail firms. The IRS will then match this information on lifestyles with its records to locate families which are not paying enough in income taxes. Surely, there are other programs that could be undertaken by government to seek out the noncompliant taxpayer.

The underlying point to all tax compliance proposals is, of course, the yield that will ultimately be produced. Government estimates of the revenue to be brought in by the new compliance measures give one food for thought. Gross proceeds reporting is estimated at generating additional revenues of $22 million in 1983, $120 million in 1984, and about $920 million in the following three years together. Expanded interest, dividend and OID reporting is to produce $43 million in 1983 and $287 million in 1984, escalating to $1.2 billion in 1987. The revenues garnered by backup withholding are less than $5 million in 1984, $113 million in 1985, and $1.4 billion in the next two years. In sum, the first two TEFRA provisions will generate about $65 million in 1983 and all three measures will produce less than $412 million in 1984. Contrasted with the estimated costs to the private sector and a triple digit deficit, these are indeed paltry sums!

While the system of cross checks and balances may become increasingly elaborate, the basic question remains: will the IRS have sufficient resources to make use of the information received as well as to follow up on the noncompliant taxpayer. In fact, one might question whether there are sufficient resources to adequately use the plethora of information that will be received under TEFRA. Finally, it is sobering to recognize that the recent flurry of legislation in the tax compliance area is based on only estimates using outdated figures. There has been little, if any, review of IRS estimates by the private sector and no reliable estimates of the additional costs TEFRA has imposed on the private sector. This is the least that can be done before additional legislation is initiated aimed at closing the "tax compliance gap" further.

Carolyn Hildebrandt
Associate Director
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SECURITIES INDUSTRY STATISTICS

VOLUME

	AUGUST 1983	YEAR-TO-DATE 1983	AUGUST 1982	YEAR-TO-DATE 1982	% CHG. Y-T-D 1983 - 1982
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	74.2	85.3	76.0	55.2	54.5%
AMEX (MILS.)*	6.3	8.9	5.6	4.3	107.0
NASDAQ (MILS.)*	54.4	63.3	30.9	27.5	130.2
REGIONAL EXCHANGE (MILS.)	11.0	12.2	10.8	7.7	58.4
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	61,555	507,164	46,181	260,410	94.8
AMEX (MILS.)	2,249	22,046	1,213	8,666	154.4
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,842	61,962	5,436	37,120	66.9
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,203	116,992	12,578	78,945	48.2
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	46.7	44.1	42.8	40.7	--
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	6,801	48,668	8,361	45,512	6.9
AMEX OPTIONS	2,868	24,010	3,994	22,678	5.9
COMMODITY	14,719	93,791	10,826	72,382	29.6

** MONTHLY AVERAGE*

YIELDS

(MONTHLY AVERAGES)

	SEPTEMBER 1983	SEPTEMBER 1982	BASIS POINT CHANGE
BOND BUYER INDEX (20 BOND)	9.6	10.66	(1.06)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	12.37*	12.94	(0.57)
Baa CORPORATE	13.55*	15.63	(2.08)
RATIO Aaa CORPS. TO Baa CORPS.	0.91	0.83	0.08
MUNICIPAL BOND YIELDS (MOODY'S)	8.97	9.76	(0.79)

PRICES

(END OF MONTH)

	SEPTEMBER 1983	SEPTEMBER 1982	% CHANGE Sept '83 - Sept '82
DOW JONES INDUSTRIALS	1233.13	896.25	37.6%
STANDARD & POOR'S 500	166.07	120.42	37.9
NYSE COMPOSITE	96.24	69.18	39.1
AMEX MARKET VALUE INDEX	230.28	283.18	(18.7)
VALUE LINE COMPOSITE	199.13	131.95	50.9
NASDAQ COMPOSITE	296.65	187.65	58.1

* Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

	AUGUST 1983	Yr.-to-Date 1983	AUGUST 1982	Yr.-to-Date 1982	% Change Y-T-D '83 to Y-T-D '82
NET SALES*	814.3	12,833.4	580.0	2,801.4	358.1%
NET PURCHASE OF COMMON STOCK*	939.6	9,433.3	649.3	407.2	2,216.6
NET PURCHASE OF OTHER SECURITIES*	136.7	1,008.5	717.2	1,662.2	(37.8)
MUTUAL FUND CASH POSITION	8.3	---	11.6	---	--

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

	SEPTEMBER 1983	September 1982	% Change Sept'83-Sept'82
MARGIN DEBT OUTSTANDING ($MILS)	19,760*	10,950	80.5
NET CHANGE IN MARGIN DEBT ($MILS)	8,810	(2,810)	--
% OF ACCOUNTS WITH EQUITY UNDER 40%	9	9	--

* NEW HIGH

UNDERWRITING
(DOLLARS IN MILLIONS)

	AUGUST 1983	Yr.-to-Date 1983	AUGUST 1982	Yr.-to-Date 1982	% Change Aug - Aug	% Change 1983-1982
CORPORATE FINANCING (Gross New Issues)						
Total	6,300	71,946	9,256	41,658	(31.9)	72.7
Common Stock	3,027	28,515	1,490	7,608	103.2	274.8
# Of Common Stock Issues	156	1,035	39	377	300.0	174.5
Preferred Stock	571	6,647	545	3,066	4.8	116.8
# Of Preferred Stock Issues	9	94	8	50	12.5	88.0
Corporate Debt	2,703	36,785	7,221	31,338	62.6	17.4
# Of Corporate Debt Issues	41	436	77	336	(46.8)	29.8
MUNICIPAL FINANCING* (Gross New Issues)						
Total	10,666	79,111	11,401	72,981	(6.4)	8.4
Notes	4,101	26,097	4,766	30,127	(14.0)	(13.4)
Bonds	6,565	55,662	6,635	42,854	(1.1)	29.9
# of Bond Issues	398	4,147	365	2,800	9.0	48.1
Negotiated Bonds	4,523	39,186	4,795	29,506	(5.7)	32.8
Revenue Bonds	4,226	38,511	4,615	29,161	(8.4)	32.1

*Preliminary Figures

These tables were prepared by Sandra Gallier-Philpotts

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	Second Quarter 1983	Yr.-to-Date 1983	Second Quarter 1982	Yr.-to-Date 1982	% Change 2nd Q. 1983 2nd Q. 1982	% Change Yr.-to-Date 1983-1982
REVENUE						
SECURITIES COMMISSION INCOME	2,391	4,503	1,115	2,272	114.4%	98.2%
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	2,028	4,206	1,298	2,370	56.2	77.5
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	1,003	1,846	436	796	130.0	131.9
TOTAL REVENUE	7,973	15,162	4,953	9,488	61.0	59.8
TOTAL EXPENSES	6,509	12,405	4,662	9,027	39.6	37.4
NET INCOME BEFORE TAXES	1,464	2,757	291	461	403.1	498.0
PERCENT OF FIRMS SHOWING LOSS	12.4%	--	37.9%	--	--	--

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
Securities Industry Yearbook 1983-84	Fourth annual edition of a comprehensive statistical guide to the securities industry. Three main sections of the book contain: 1. rankings of firms based on capital, RRs, branch offices and employees; 2. detailed information on individual firms; and 3. key industry and market data.	Publications Dept. SIA 120 Broadway New York, New York $35 members/$50 non-members
Competition in the Investment Banking Industry	In this 177-page book, authors Hayes, Spence and Marks provide a comprehensive analysis of the current competitive structure of the industry. After sketching the history and evolution of investment banking, the patterns of concentration and the strategic and economic factors underlying those patterns are explored.	Harvard University Press Cambridge, Massachusetts and London, England 1983
"Deregulation: Riding the Rapids"	Drawing on a study of companies in five industries that have been deregulated in the past 10 years, author Bleeke describes four successful deregulation strategies and suggests how astute top management can avoid some of the trauma by developing an explicit deregulation agenda well in advance of the event, rethinking relations with customers, considering new roles to play in the market and realigning their organizations accordingly.	The McKinsey Quarterly Summer, 1983
"Winning Strategies for Interstate Banking"	Bank deregulation is taking place through the "back door" in states rather than Congress. States are letting local banks convert into large institutions that can presumably stand up to the money center banks when interstate banking arrives. However, the author points out that few banks have come up with promising strategies for mergers.	Fortune 9/19/83

ITEM	DESCRIPTION	SOURCE
"The Six-Month Underwriting Sweepstakes"	Statistical tables ranking underwriters in corporates, municipals, and syndicated loans. Three method rankings for each category: bonus-credit to lead manager, full credit to lead manager, and full credit to each manager.	Institutional Investor 9/83
"Citibank Takes on Merrill Lynch in the Battle of the Giants"	Brief article explaining the advantages and disadvantages faced by banks and brokers in marketing the central asset account.	Dun's Business Month 10/83
"How to Choose a Discount Broker"	Today, over 2,000 banks offer discount brokerage and their ranks are increasing weekly. Article explains difference between full-service and discounter, as well as the nuances among discounter themselves. Table depicting 30 least expensive firms.	Barron's 10/17/83
"The Trouble with 415s"	Review of SIA position letter to the SEC on Rule 415 and the two studies used to support that position, one conducted by SIA and the other by Opinion Research Corp. SIA believes that debt securities ought to remain under shelf registration as it stands now, but that there ought to be new rules for equity offerings. SIA suggests offerings other than investment grade convertible debt and preferred stock be registered on an issue-by-issue basis, with a minimum time set between filing and effectiveness of the legislation statement.	Investment Dealer's Digest 9/27/83